LECTURE 1

Overview of Managerial Finance and Financial Markets

Introduction

Finance can be understood as the field of study regarding all aspects of money. This course more narrowly focuses on managerial finance which concentrates on the optimal methods to acquire and use funds to maximize the value of the entity (Moyer, McGuigan, and Kretlow, 2009).

This is pertinent to the contemporary business leader because the best of ideas and the brightest companies cannot succeed without effective financial management. Additionally, business leaders now have a responsibility (legal, as principal-agent, and ethical) to be competent in finance. Whether it is the responsibility management has to the ownership, complying with laws like Sarbanes-Oxley, or balancing a shareholder wealth maximization concept with stakeholder theory (Moyer et al., 2009), business leaders have the challenge of being competent financial managers.

Different Forms of Business Organizations

There are three primary forms of business organization with various subsections. These distinctions are further complicated by various state and federal laws. The primary business forms are: (a) sole proprietorship, (b) partnership, and (c) corporation.

Generally, a sole proprietorship is an unincorporated business owned by one individual.

A partnership is formed when two or more people own an unincorporated business. However, partnerships have evolved due to the need to limit legal liability; there are now limited partnerships, limited liability partnerships, and limited liability companies.

Finally, there is a corporation − from the Latin corpus meaning 'body'-- that is, a legal entity with rights and responsibilities governed by state and federal laws (Brigham and Ehrhardt, 2008).

Maximizing Shareholder Wealth versus Stakeholder Theory

Profit maximization is not shareholder wealth maximization. Shareholder wealth maximization = number of shares outstanding x market price per share (Moyer et al., 2009).

Going back as far as 1970, a discussion regarding the responsibility of the corporation has been waged. One part of the discussion suggests that corporations have a social responsibility to do business in a manner that serves stakeholders-- employees, suppliers, the community, shareholders, and any other group with a stake in the performance of the company (Daft, 2010).

The other part of the discussion proposes that the most socially responsible manner in which to conduct business is to maximize the wealth of the shareholders in a legal and ethical manner. This approach, it is argued, actually creates the most societal benefit: jobs, economic output, wealth (Friedman, 1970). Recently, arguments have been posed and seem to be gaining traction that these concepts are not as mutually exclusive as they may seem. Either way, corporate social responsibility, shareholder wealth maximization, or the stakeholder-model are all concepts contemporary business leaders must be prepared to navigate.

Financial Markets

The primary function of the financial system is to assist in the movement of money from surplus spending units to deficit spending units (Moyer et al., 2009). This is done through financial intermediaries who balance claims from borrowers and lenders. In one example, depositors are actual lenders to the bank and their bank balances are reflected as liabilities on the bank's balance sheet, and the borrowers' loans are reflected as assets. Financial markets consist of the money markets (short-term maturities) and capital markets (longer term maturities) where financial assets are bought and sold. One important concept in the financial markets is the idea of efficient markets-- security prices are accurate and instant reflections of relevant information regarding the risk and return of the security (Moyer et al., 2009). Efficient markets provide a "level playing field" for all participants and there are laws prohibiting trading on information that is not public or "insider information."

Recent history provides a stark lesson as to how important the financial markets are to the financial health of the overall economy. In 2008 the mortgage-backed security market suffered a major decline making money harder to access and resulting in an economy-wide recession. Tighter money, as a result of subprime foreclosures, exacerbated the economic environment decline. In addition, contemporary insider-trading trials like that of Galleon co-founder Raj Rajaratnam demonstrate how seriously the U.S. government construes protection of the efficient market concept (Bloomberg, 2011).

Conclusion

Regardless of how one views the responsibility of the corporation, a bankrupt business is of little use to the shareholders or the other stakeholders. Consequently, leadership's understanding of how companies interact financially both with external markets and internally is vital.

References

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